

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Chapter 20B Record Maintenance - Combined Report Issues

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R&TC §19141.6
CCR §19141.6

Training Objectives:

This section of the Water's-Edge Manual provides an analysis of California's record maintenance provisions.

One of the biggest challenges facing auditors is obtaining access to the taxpayer's relevant business records. To help alleviate difficulties in obtaining necessary records, R&TC §19141.6 was enacted effective for income years beginning on or after January 1, 1994. The section applies to **ALL** apportioning or water's-edge taxpayers.

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a. Introduction

Senate Bill 671 (Stats. 1993, Chp. 881) added R&TC §19141.6, applicable to income years beginning on or after January 1, 1994. The section is patterned after IRC §6038A, but provides additional record keeping requirements that are tailored to California's apportionment method. R&TC §19141.6 provides the Franchise Tax Board (FTB) with new powers to require taxpayers to maintain records for the audit of their state tax returns. Taxpayers that fail to comply with the record keeping provisions may be subject to penalties and under certain circumstances a redetermination of income based on available information.

The section requires every apportioning and/or water's-edge taxpayer to maintain certain records regarding the determination of the components of any unitary business of which the taxpayer is a part, the apportionment factors of such business, the classification of an item of income or loss as business or nonbusiness, and the attribution of income to either foreign jurisdictions or the U.S. for the taxpayer and related parties under §482, §882, Subpart F, or other similar sections of the Internal Revenue Code. Penalties, which are essentially the same as those imposed by IRC §6038A, are provided for failure to maintain or to cause another to maintain records for the designated period and make them available to the FTB. There is a reasonable cause exception to the penalties, which is interpreted liberally for small banks and corporations. The FTB is also empowered to redetermine income in the event of nonproduction of records in certain specified situations.

R&TC §19141.6 addresses the following:

1. Record maintenance requirement
2. Monetary penalty for failure to maintain records
3. Authorization of agent
4. Enforcement proceedings
5. Noncompliance redetermination

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b. Record Maintenance Requirements

1. Record Maintenance

R&TC §19141.6 is patterned after IRC §6038A with adaptation to state tax requirements. The duty of taxpayers to maintain records is broadly stated in the statute. The statute provides for the promulgation of regulations to prescribe the location, the manner and the extent to which books and records must be maintained by the taxpayer. Extensive regulations providing guidance on the application of the code section have been issued by the department and became effective April 27, 1996.

R&TC §19141.6 requires corporate taxpayers, which are subject to allocation and apportionment or which have elected water's-edge, to maintain (or have a related party maintain) and make available records and information relating to the determination of:

- the components of the unitary business(es) of which the taxpayer is a part,
- the classification of individual items of income or loss as business or nonbusiness,
- the apportionment factors for each unitary business of which the taxpayer is a part, and
- the attribution of income to United States and foreign jurisdictions under IRC §882 (foreign corporations with effectively connected income), Subpart F provisions, or other similar sections of the IRC.¹

The record maintenance requirements include records of the taxpayer and all members of the combined report group of which the taxpayer is a part, as well as records of any excluded affiliate that may be relevant to determine the correct California tax liability.²

With the following exceptions, no documents are required to be created. The statute and the regulations contemplate retention of records that are created in the ordinary course of business. However, the taxpayer must create and maintain (or cause a related party to create and maintain) the following records if they are not otherwise created:³

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- Basic accounting records that are sufficient to document the California tax effects of transactions between related parties, and
 - Records sufficient to produce material profit and loss statements that are relevant for determining the California tax treatment of transactions between the combined report group and an excluded affiliate.

The taxpayer is required to retain and provide on request all record and retention procedures and policies in effect for each income year. The taxpayer must also retain all internal record storage and retrieval systems used for each year.⁴

2. Special Rules For Water's-Edge Taxpayers

In general, the regulations provide that water's-edge electors need to maintain records necessary to determine the components of the unitary business, apportionment factors, and classification of income or loss as business or nonbusiness only with respect to the affiliates required to be included in the water's-edge combined report.⁵ However, the FTB may require a taxpayer to keep records for affiliates not required to be included in the combined report if it is determined by the FTB, in its sole discretion, that those records are necessary to properly determine the components of the unitary business, the apportionment factors, or the proper classification of income or loss as business or nonbusiness.⁶ Water's-edge taxpayers are required to maintain the following records with respect to related parties not required to be included in the combined report:

- Records sufficient to determine the proper attribution of income to either foreign jurisdictions or the U.S. for taxpayer and its related parties,⁷ and
- Records required to be maintained for purposes of IRC §6038A, and information relating to ownership and capital structure.⁸

Example 1:

P, an U.S. corporation doing business in California, owns 100 percent of the stock of F, a corporation incorporated in Foreign Country X. F is the European distribution agent for tangible personal property manufactured in the U.S. by P. P elected water's-edge and excluded F from its combined report. Because F is excluded from the combined report filed by P, records created by F that would be

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relevant to determining its apportionment factors and the correct calculation of its income or loss as business or nonbusiness will generally not be subject to the record maintenance requirements of §19141.6. If, however, it is determined at audit that the income and apportionment factors of F are required to be included in the combined report filed by P (because, for example, F is determined to have Subpart F income), all records relevant to determining the apportionment factors or the classification of income or loss as business or nonbusiness will be subject to the record maintenance requirements.

3. Translation Of Records

When records are provided to the FTB which are in a foreign language, they must generally be translated into English within 30 days of a request for translation by the FTB. Reasonable requests for extensions of the 30-day translation period will be liberally granted. In addition, if there are numerous documents of a similar nature, translation of an appropriate sampling of the documents may be offered in lieu of translating all the documents. The taxpayer may, however, be required to translate all of the documents if it is determined such translation is necessary to perform or complete an audit.⁹

4. Location Of Records

The records are generally required to be maintained in the U.S. However, the taxpayer may maintain, or cause another to maintain, records outside the U.S. if the records are ordinarily maintained outside the U.S. and the taxpayer delivers the records (or duplicates) to the FTB within 60 days of a request for the records. The taxpayer may make a written request for an extension of the 60-day period. The request for extension must be made within 30 days of the FTB request for the records.¹⁰

If records required to be maintained are in the control of a foreign related party, the records may be obtained and compiled by the taxpayer, a third party or by the foreign related party. A foreign related party may, upon the FTB's request for the records, arrange to furnish the records directly to the FTB rather than through the taxpayer.¹¹

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5. Examination And Copying Of Records

Documents are to be provided in the form in which they are kept in the usual course of business. Records that are stored or maintained on computers or electronic media may be provided in either printed or electronic form. If records are provided in electronic form, the taxpayer must comply with the procedures in Revenue Procedure 91-59 and must provide the records on a medium which includes both the data and the program which is used to compile and analyze the data, and instructions for the use of such program.

Records shall be produced for examination and copying at the Program Office of the Franchise Tax Board, at the Headquarters of the taxpayer, or at any other location within the US that is convenient for both the taxpayer and FTB. For large document productions, if the FTB will not copy or arrange for copying of the documents at the place of delivery, a taxpayer may request reimbursement for the cost of copying documents at a rate not to exceed the cost at which the FTB can contract for the services of a third-party copying service. A large document production is a document production involving the copying of in excess of 1,000 pages, provided that the FTB auditor has been allowed to examine all of the documents and designate those documents that are to be copied. Documents which are copied for purposes of complying with the U.S. record maintenance requirement do not constitute a large document production.¹²

6. Retention Period

Records for any year must be retained for the longer of:

- The time during which the taxpayer's franchise or income tax is subject to adjustment but not to exceed 8 years from due date or extended due date of return;
- The period of time during which a protest is pending;
- The period of time during which an appeal is pending before Board of Equalization;
- The period of time during which a suit for refund is pending in the courts of California or of the United States.

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However, a taxpayer need not maintain any records beyond the 8 year time period for issues which are not the subject matter of the dispute in the protest, the appeal, and/or the claim for refund.¹³

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c. Safe Harbor

A safe harbor is provided in the regulation. It is an all-purpose listing of the record types that could be relevant to taxpayers. It states plainly that not all taxpayers must maintain each category of items enumerated, but rather only those which may be relevant to its business or industry. A taxpayer using "reasonable approximations" as provided for in CCR §25106.5-3 must maintain the records of the data upon which the approximations were made and the manner in which they were made.¹⁴

The following records must be maintained in order to satisfy the safe harbor to the extent they may be relevant to determine the correct treatment of an item or entity for purposes of R&TC §25101 or 25110, or the correct California tax treatment of transactions between the combined report group and an excluded entity.

1. **Financial records and tax data** - This category includes financial statements, workpapers, and books and records of original entry or their equivalents.¹⁵
2. **Profit and loss statements** - This category includes records from which the taxpayer can compile and supply, within a reasonable time, material profit and loss statements of the taxpayer and all related parties that reflect profit or loss of the related party group attributable to U.S.-connected products or services. U.S. connected products or services means products or services that are imported to or exported from the U.S. by transfers between the taxpayer and any of its excluded foreign related parties. See the regulation for information on what the profit and loss statements should contain, and the test for determining whether a profit and loss statement is material.¹⁶
3. **Apportionment factor records** - This category includes books and records for each separate entity in the combined report group for which apportionment factor numerators and denominators are determined. Examples include¹⁷:
 - Fixed asset ledgers by location with details of historical cost by year of acquisition,
 - Inventory records by location, including details of inventory in-transit at year end,
 - Rental and lease agreements,

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- Payroll records, and
 - Sales journals detailing sales of tangible personal property by shipping point origin and destination
4. **Foreign country and third party filings** - This category includes financial and other documents filed with or prepared for any U.S. or foreign government entity, independent commission, or financial institution.¹⁸
 5. **Ownership and capital structure records** - This category includes records or charts showing the relationship between the taxpayer and all related parties, the location, ownership and entity status of the taxpayer and all related parties, and a worldwide organization chart.¹⁹
 6. **Management structure** - This category includes records showing the management relationship, including any centralized or decentralized services, between the taxpayer and all related parties. Examples include records detailing the corporate officers, directors, and top management, job descriptions of such individuals, minutes of the Board of Directors meetings, and correspondence files of officers and directors.²⁰
 7. **Records of sales transactions** - This category includes all records relevant to establishing the extent, nature, and appropriate price or rate for transactions between the combined report group and any excluded entity to the extent they are relevant to determine either the components of the unitary business or the attribution of income between the U.S. and foreign jurisdictions.²¹
 8. **Records of loans, services, and other non-sale transactions** - This category includes relevant records relating to²²:
 - Loans and guarantees of debt between the combined report group and any excluded affiliate,
 - Research and development expense allocations between the combined report group and any excluded affiliate,
 - Service transactions between the combined report group and any excluded affiliate,
 - Agreements or other records for the shared use of facilities,
 - Registration of patents, trademarks, copyrights, and other similar property with respect to transactions between the combined report group and any excluded affiliate.

See the regulation for more detailed information on the safe harbor record requirements.

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d. Monetary Penalty And Other Remedies

1. Imposition Of The Monetary Penalty

- A. A **\$10,000** penalty will be assessed for each income year that the taxpayer fails to maintain (or cause another to maintain) the records required by R&TC §19141.6, or in the case of records maintained outside the U.S., fails to timely bring the records to the U.S. The Director of Multistate Audit Program Bureau or the Director, Multistate Tax Bureau (Legal) makes the determination whether or not the penalty should be assessed, and the penalty is subject to the approval of a majority of the 3-member Franchise Tax Board.
- B. If the taxpayer fails to maintain records for multiple related parties, the penalty may be imposed for each failure with respect to each related party. However, no more than one penalty per related party can be imposed in any one income year.²³
- C. If the failure continues for more than 90 days after notice of the failure is mailed by FTB, the taxpayer may be subject to a penalty of **\$10,000** for each additional 30-day period (or fraction thereof).²⁴ The additional penalty will cease to accrue if the taxpayer demonstrates compliance with respect to the maintenance of records for the income year in which the examination occurs and subsequent years, and/or produces or moves the non-U.S. located records to the U.S.²⁵ There is no maximum penalty cap for income years beginning on or after January 1, 1996. For income years beginning prior to January 1, 1996, the additional penalty cannot exceed \$50,000 per related entity, if the failure is not willful.²⁶ Note: The statute specifically prohibits FTB staff from threatening the application of the penalty in order to get an agreement or raising it as a bargaining issue.
- D. The noncompliance penalty provisions also authorize the FTB to determine the components of the unitary business, the apportionment factors of the business, the classification of income or loss as business or nonbusiness, and the proper attribution of income between the U.S. and foreign

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jurisdiction. (This power will be referred to as redetermination.) A redetermination can be made if the taxpayer did not maintain the records, or if they are maintained and the taxpayer did not furnish them. A subpoena must be issued before a redetermination can be made. The Director of Multistate Audit Program Bureau or the Director, Multistate Tax Bureau (Legal) makes this redetermination.²⁷

No employee shall mention, discuss, or threaten the potential use of the power to redetermine (under CCR 19141.6 (k)) without the prior express written authorization from the Director of Multistate Audit Program Bureau. If an auditor believes that a redetermination is appropriate, an explanation and supporting documentation should be provided to the Director of Multistate Audit Program Bureau, who will make a written recommendation to the Executive Officer. A redetermination must be expressly approved by the Executive Officer.

2. Reasonable Cause

The monetary penalty may be excused for reasonable cause. Normal reasonable cause provisions apply. To show that reasonable cause exists, the taxpayer must make an affirmative showing of all the facts alleged as reasonable cause in a written statement containing a declaration that is made under penalties of perjury. The statement must be filed with the Director, Multistate Audit Program Bureau, and the Director will determine whether the failure was due to reasonable cause.²⁸

Reasonable cause is to be liberally interpreted for small corporations that had no knowledge of the record maintenance requirements, has limited presence in and contact with California, and promptly and fully comply with all requests to furnish information. A small corporation for purposes of applying the penalty provisions is defined as a corporation whose gross receipts or net assets for an income year are \$50,000 or less.²⁹

Note: Taxpayers have retention/destruction dates for all records. They are already aware of the need to keep records that might relate to federal audit issues. They may not be aware of the need to keep records for unity, apportionment, or business income issues. Many of these records will have a short retention period. Thus, we should make them aware of the requirements of

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§19141.6 and CCR §19141.6 so that they do not destroy relevant records in accordance with their existing destruction dates.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

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e. *Authorization Of Agent*

Upon request by the FTB, a foreign related party must authorize the California taxpayer as its limited agent, solely for purposes of powers of examination with respect to any request by the FTB to examine records or produce testimony that may be relevant to the determination of the components of the unitary business, the apportionment factors of such business, the classification of income or loss as business or nonbusiness, and the proper attribution of income between U.S. and foreign jurisdictions.³⁰

The noncompliance penalty (see Chapter 20B(d), Water's-Edge Manual.) will apply if the foreign related party fails to authorize the California taxpayer as its agent.³¹ In exceptional circumstances the California taxpayer may be deemed to be an authorized agent in cases where the foreign related party fails to authorize the taxpayer to be its agent.³²

In *Asat v. Comm'r*, 108 T.C. No 11, dated March 31, 1997, the federal noncompliance penalty was upheld when the foreign related party failed to appoint an agent when requested by the Internal Revenue Service. Thus, the noncompliance penalty was imposed on the taxpayer and the Internal Revenue Service was entitled to resort to IRC §6038A(e)(3) and make adjustments based on information available.

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f. Subpoena Duces Tecum

The noncompliance penalty (see Chapter 20B(d), Water's-Edge Manual.) will apply if a subpoena or subpoena duces tecum is issued to the taxpayer to produce any records either directly or as agent for a foreign related party, relevant to determine the components of the unitary business, the apportionment factors of such business, the classification of income or loss as business or nonbusiness, and the proper attribution of income between U.S. and foreign jurisdictions **and if**:

- the subpoena is **not** quashed or determined to be invalid, and
- the taxpayer does not substantially and timely comply with the subpoena and the FTB has sent by certified or registered mail a notice to the taxpayer that it has not complied, **or**
- the taxpayer fails to maintain or cause another to maintain records and by reason of that failure, the subpoena is quashed or the taxpayer is not able to provide the records requested in the subpoena.

A legal proceeding to enforce the subpoena is not required in order to apply the noncompliance penalty.³³ The courts have jurisdiction to hear the motion to quash the subpoena. The statute of limitations is suspended during the judicial proceeding.³⁴

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g. Summary

R&TC §19141.6 requires the taxpayer to maintain, and cause their related parties to maintain, books and records relating to their unitary business, classification of business or nonbusiness income, apportionment factors, and attribution of income to U.S. or foreign sources.

The taxpayer is subject to substantial monetary penalties and to a noncompliance penalty adjustment for failure to comply. All taxpayers filing on a worldwide or a water's-edge basis are subject to the record maintenance provisions.

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Footnotes

1. R&TC §19141.6(a), CCR §19141.6 (a)(1)
2. CCR §19141.(c) (1)(D)
3. CCR §19141.6 (e)(1)(B)
4. CCR 19141.6 (e)(1)(C)
5. CCR §19141.6(c)(1) (B)
6. CCR §19141.6(c)(1)(B)(4)
7. CCR §19141.6(c)(1)(B)2
8. CCR §19141.6(c)(1)(B)3
9. CCR §19141.6(d)(3)
10. CCR §19141.6(d)(2) and (g)
11. CCR §19141.6(d)(2)
12. CCR §19141.6(h)
13. CCR §19141.6(i)
14. CCR §19141.6(c)(2)(B)
15. CCR §19141.6(e)(2)(A)
16. CCR §19141.6(e)(2)(B) and CCR §19141.6(e)(3)
17. CCR §19141.6(e)(2)(C)
18. CCR §19141.6(e)(2)(D)
19. CCR §19141.6(e)(2)(E)
20. CCR §19141.6(e)(2)(F)
21. CCR §19141.6(e)(2)(G)
22. CCR §19141.6(e)(2)(H)
23. CCR §19141.6(j)(1)(B)
24. CCR §19141.6(j)(4)(A)
25. CCR §19141.6(j)(4)(B)
26. R&TC §19141.6(c)(2) and CCR §19141.6(j)(4)(D)
27. CCR §19141.6(k) and (l)(3)
28. CCR §19141.6(j)(2)
29. CCR §19141.6(j)(2)(B)(2)
30. CCR §19141.6(n)(1)
31. CCR §19141.6(n)(3)(B)
32. CCR §19141.6(n)(6)
33. CCR §19141.6(k)
34. CCR §19141.6(k)(4)